

Unrelated income; royalties received as patent owner. Amounts received from licensees by an exempt organization, the legal and beneficial owner of patents assigned to it by inventors for specified percentages of future royalties, constitute royalty income that is excludable in computing unrelated business taxable income; Rev. Rul. 73-193 distinguished.

Advice has been requested whether, under the circumstances described below, amounts received by an organization subject to the provisions of section 511 of the Internal Revenue Code of 1954 constitute royalty income excluded in computing unrelated business taxable income within the meaning of section 512(b)(2).

The organization is exempt from Federal income tax under section 501(c)(3) of the Code. It was formed to promote scientific investigation and research at a university. In furtherance of this purpose, the organization makes annual grants to the university. In addition, the organization accepts inventions of individuals associated with the university for evaluation and possible patent consideration.

If the organization decides that an invention is a new discovery, it files a patent application. At that time the inventor executes an irrevocable assignment of both his legal and beneficial rights in the invention to the organization which in return agrees to pay a specified percentage of royalties subsequently received from licensees.

Section 512(a) of the Code provides that the term 'unrelated business taxable income' means, with certain modifications, the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions. Section 512(b)(2) provides that in determining unrelated business taxable income there shall be excluded all royalties (including overriding royalties), whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

Section 1.512(b)-1 of the Income Tax Regulations provides that whether a particular item of income falls within any of the modifications provided in section 512(b) of the Code shall be determined by all the facts and circumstances of each case. For example, if a payment termed 'rent' by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment is not within the modification for rents.

Rev. Rul. 73-193, 1973-1 C.B. 262, holds that patent development and management service fees deducted by an organization exempt under section 501(c)(3) of the Code from royalties that are collected by it in its capacity as patent

manager for the beneficial owners of patents do not retain the character of royalties in the organization's hands for purposes of section 512(b)(2). The organization holds bare legal title to the inventions for the account of the beneficial owners, i.e., educational and scientific institutions and the inventors on their staffs. The organization is entitled to retain for itself only an amount in payment for services rendered pursuant to an agreement to promote the inventions with respect to which it accepts legal title. Upon termination of the agreements, the inventions are assigned to the beneficial owners subject to any contracts that the organization may have entered into with respect to the inventions. As a result, income realized by the organization is not within the exception for royalty income provided by section 512(b)(2); instead, it is income received for patent development and management services.

Unlike the organization described in Rev. Rul. 73-193, the subject organization is both the beneficial and legal owner of its patents. Therefore, amounts paid to the organization pursuant to licensing agreements constitute royalty income, rather than fees for development and management services, as in Rev. Rul. 73-193.

Accordingly, amounts received by the organization from licensing fees constitute royalty income that is excludable by the organization in computing its unrelated business taxable income under section 512(b)(2) of the Code.

Rev. Rul. 73-193 is distinguished.